UNIVERSITY of FLORIDA

Subprime Lending Challenges: How we Got Here

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Chris Peterson, Associate Professor of Law

The U.S. Subprime Lending Crisis

- Currently at least *two million* American families are currently facing foreclosure.
- First decline in the national median price for previously owned homes since the Great Depression.
- 10,000 of Cleveland, Ohio’s 84,000 single-family homes are sitting vacant and rapidly deteriorating into urban blight.

The U.S. Subprime Lending Crisis

- N.Y. Times, July 18th:

  “Bear Stearns told clients in its two battered hedge funds . . . that their investments, worth an estimated $1.5 billion at the end of 2006 are almost entirely gone.”
- U.S. Capital Markets have been teetering on the edge of a panic for months. Analysts are predicting many more foreclosures over the next two years.

Why have so many Americans suddenly become unable to pay for their shelter?

Traditional explanations of insolvency:

- Advocates of disclosure law: Inadequate contract formation.
- Advocates of debtor amnesty: Health care expenses, divorce, job loss, etc.
- Advocates of cultural change: Decline in thrift and the stigma of bankruptcy

Why have so many Americans suddenly become unable to pay for their shelter?

- One additional part of the puzzle:
  - Structural incentives associated with the U.S. loan origination and funding system.

Overview

1) Development and Use of Private Label Residential Mortgage Securitization
2) Short description of the law governing home mortgage lending and securitization
3) Why has the system broken down? A few thoughts.
4) [Next session -- What should we do to fix the system?]

Historical Background

Three periods in the history of the U.S. secondary mortgage market:

- 1. Two party mortgage market
- 2. Three party mortgage market
- 3. Private securitization secondary market

Figure A -- Subprime Home Mortgage Securitization Structure

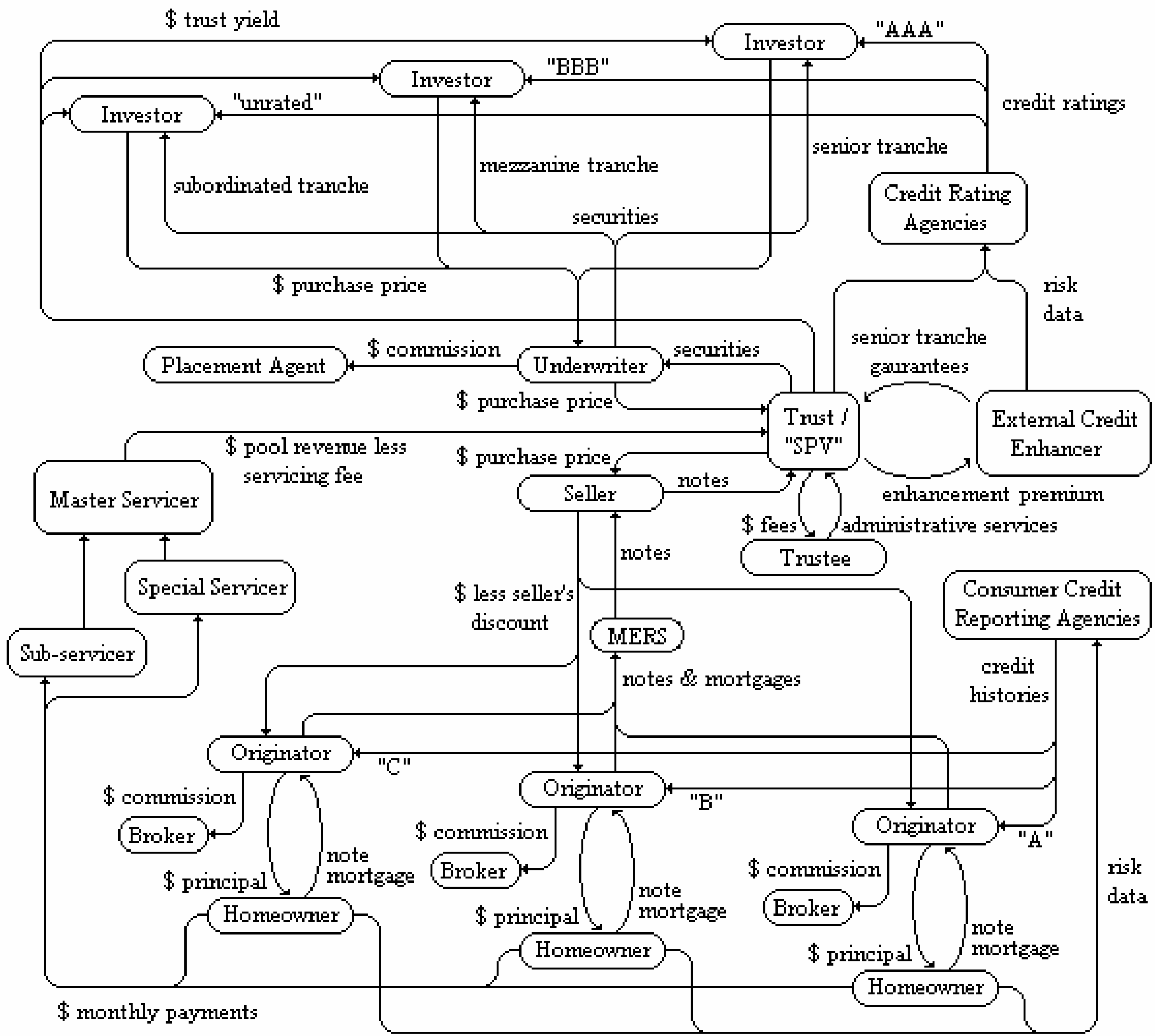


Figure A -- Subprime Home Mortgage Securitization Structure

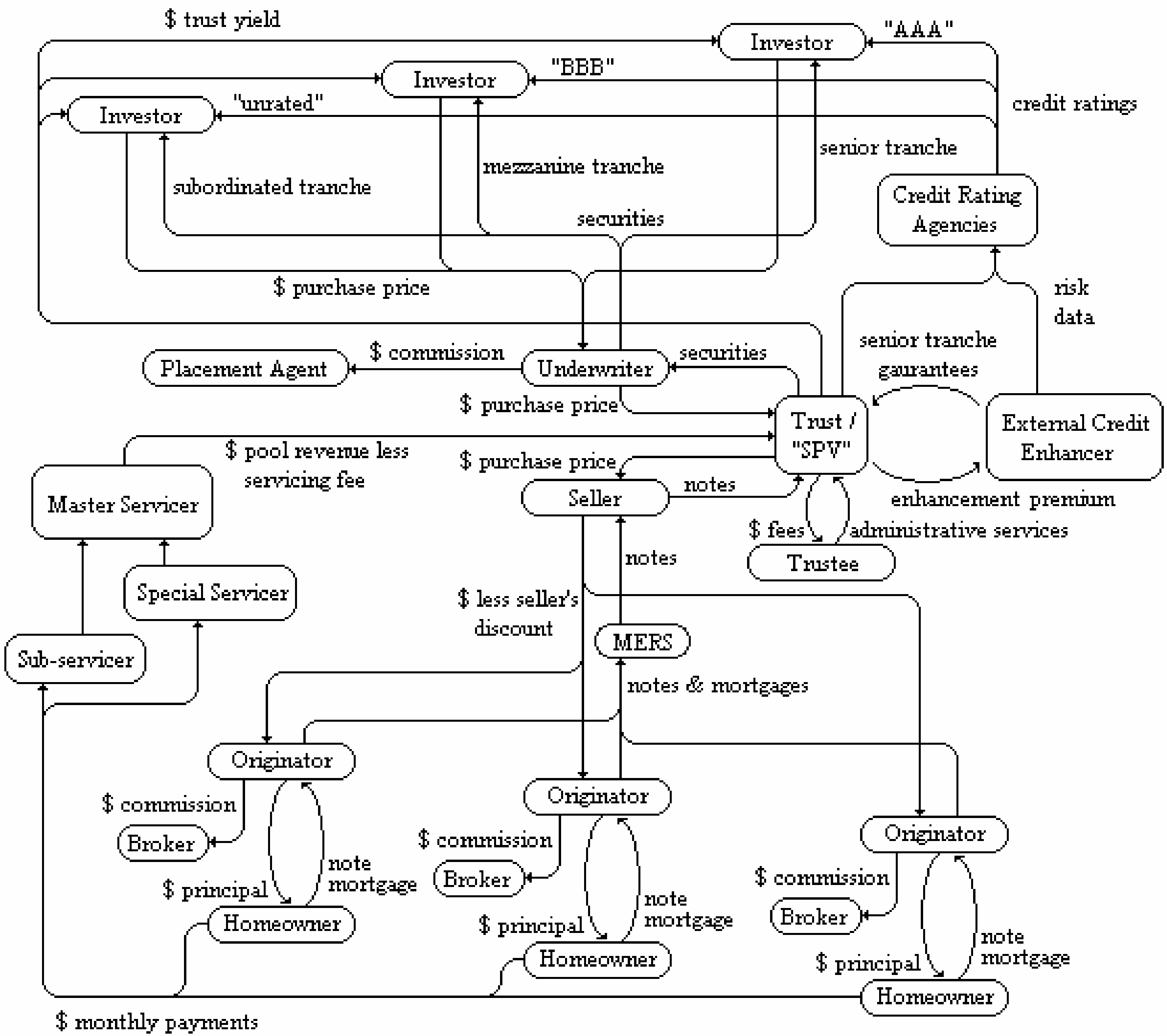
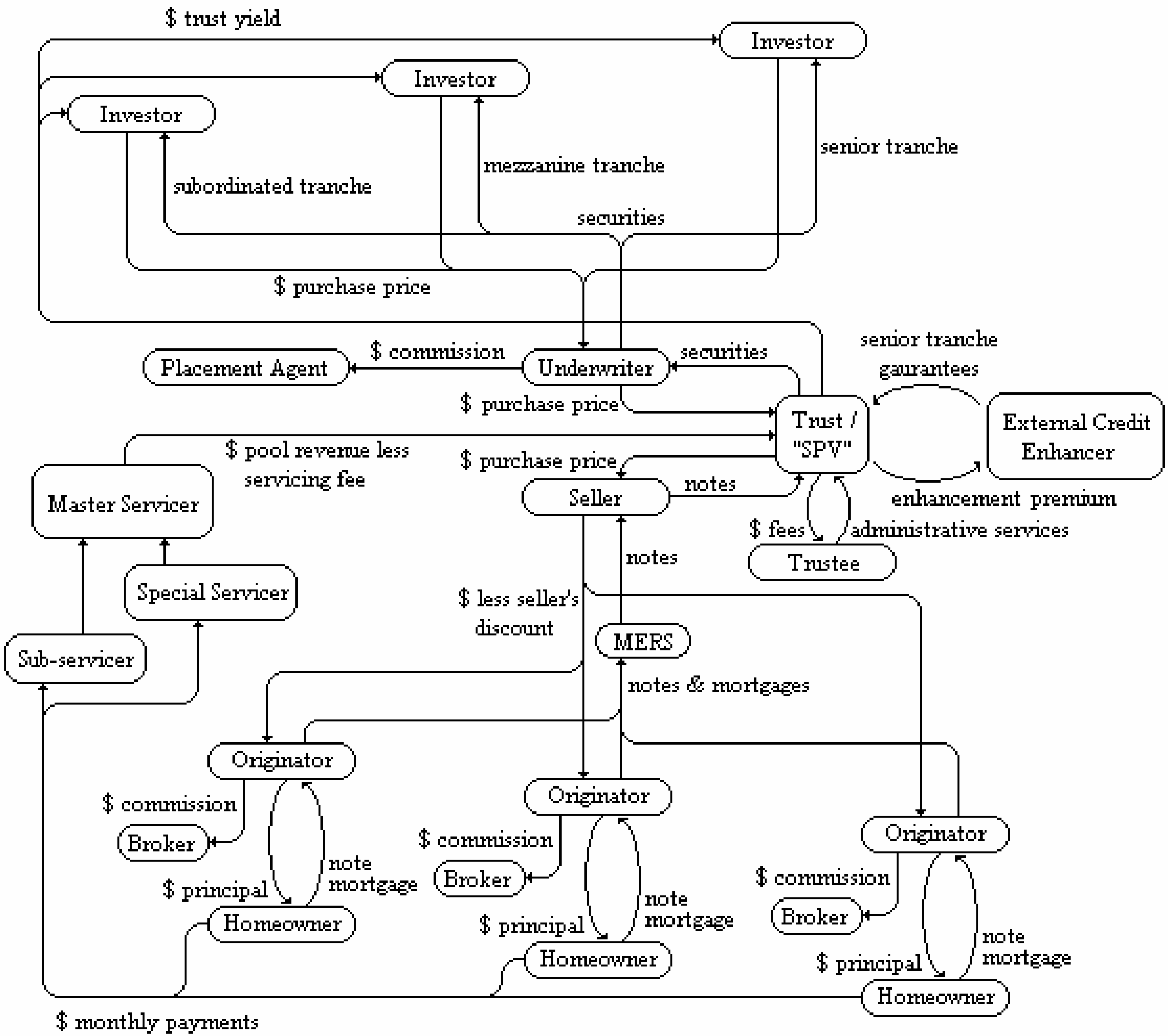
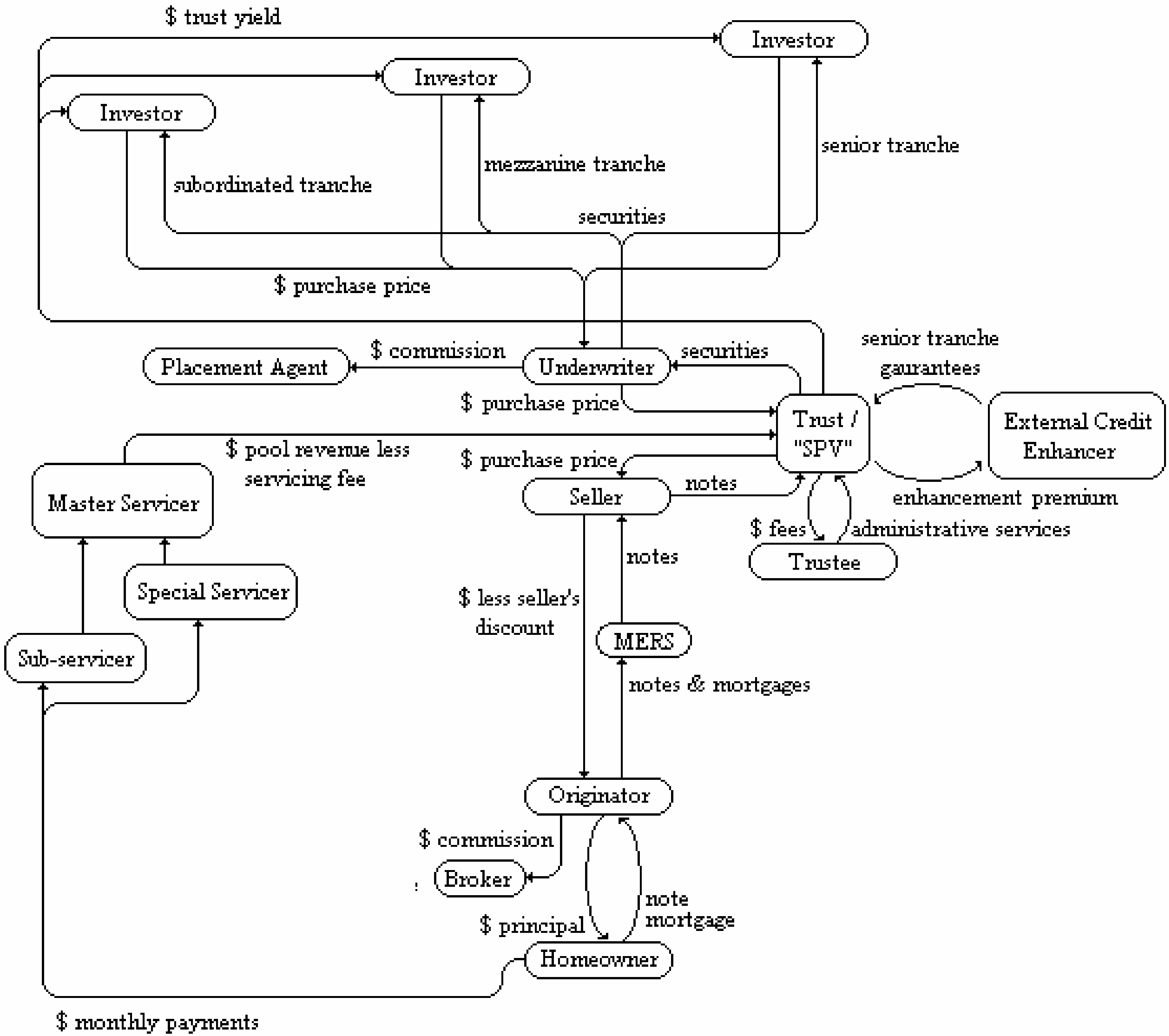
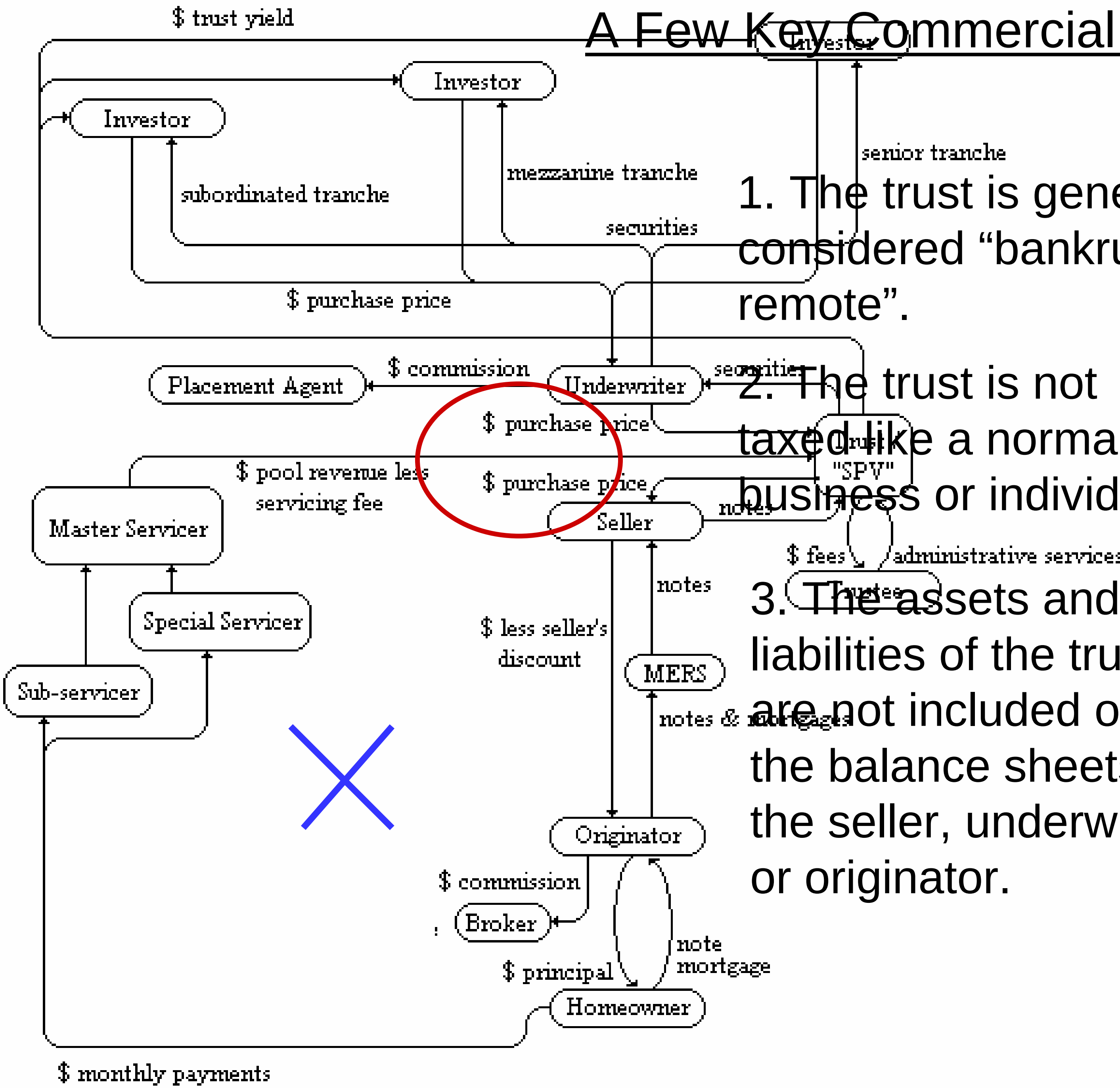


Figure A -- Subprime Home Mortgage Securitization Structure




$ trust yield
Investor
Investor
Investor
subordinated tranche
mezzanine tranche
senior tranche
securities
$ purchase price
$ commission
Placement Agent
Underwriter
securities
senior tranche
gaurantees
$ purchase price
Trust /
"SPV"
External Credit
Enhancer
$ pool revenue less
servicing fee
$ purchase price
Master Servicer
Seller
notes
enhancement premium
$ fees
administrative services
Trustee
Special Servicer
notes
$ less seller's
discount
MERS
Sub-servicer
notes & mortgages
Originator
$ commission
Broker
note
mortgage
$ principal
Homeowner
$ monthly payments

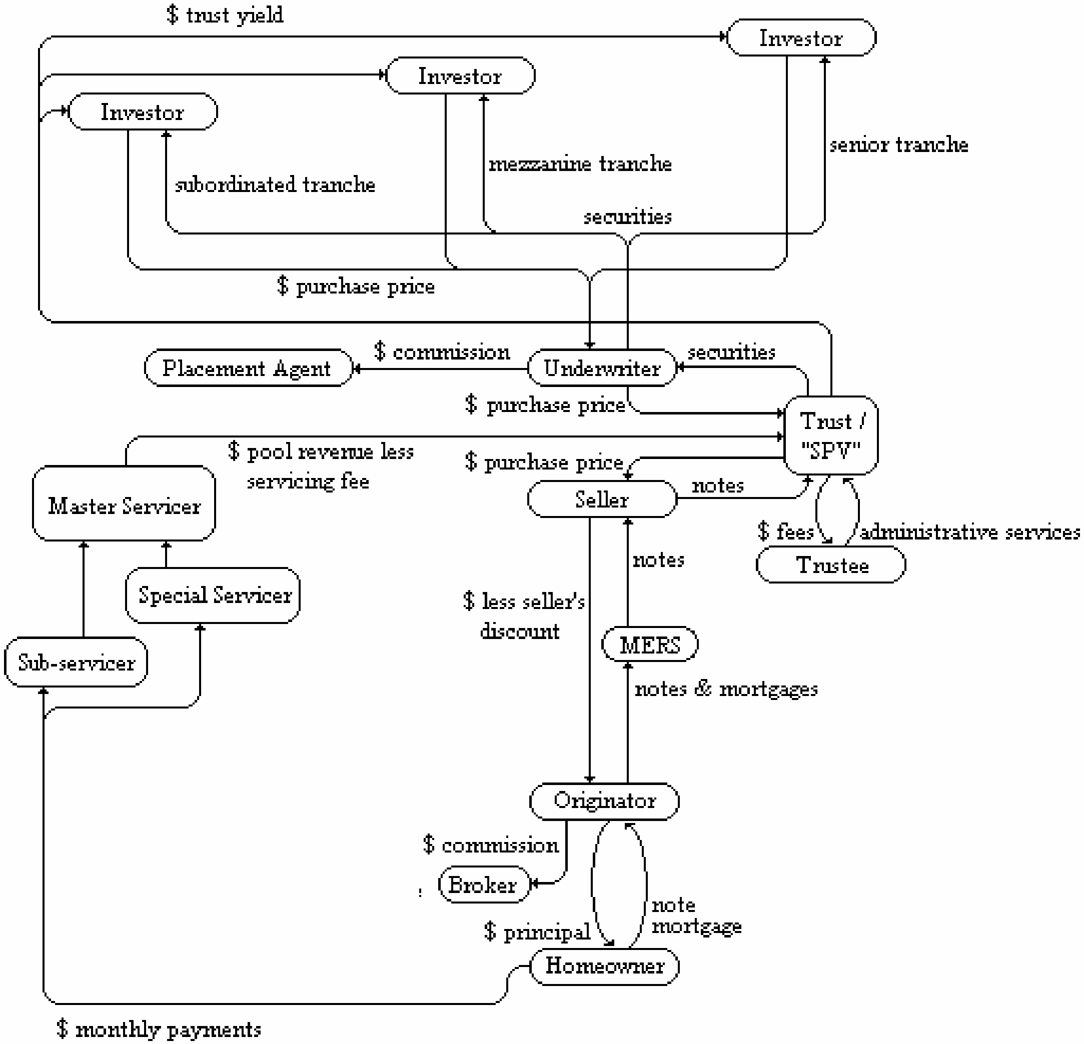
A Few Key Commercial Laws…



1. The trust is generally considered “bankruptcy remote”.

2. The trust is not taxed like a normal business or individual.

3. The assets and liabilities of the trust are not included on the balance sheets of the seller, underwriter, or originator.



A few key consumer protection laws…

1. Common law fraud
2. Truth-in-Lending Act
3. Home Ownership and Equity Protection Act
4. Real Estate Settlement Procedures Act
5. Fair Debt Collection Practices Act
6. State Foreclosure Procedures
7. Bankruptcy

Why has the system broken down?

1. Ambiguity: Consumer protection laws assume an antiquated model of mortgage finance.
2. Opacity: Enforcing consumer protection laws has become much more expensive for consumers and regulators.
3. Immunity: Securitization shelters assets from lawsuits enforcing consumer protection laws.
4. Dishonesty: We have become tolerant of commercial fictions and outright deception.

Why has the system broken down?

- fraud, misleading terms, false estimates, and inadequate disclosure
- excessive rates and fees
- Teaser rates without an underwriting-based justification
- broker commissions for loans that exceed a risk adjusted price
- high pressure sales
- inclusion of overpriced or unnecessary insurance
- unnecessarily harsh prepayment penalties
- inflated appraisals, forgery
- collusion with disreputable home improvement contractors or other vendors
- targeting of vulnerable groups, including racial minorities, immigrants, the elderly, persons with visual impairment, or persons with mental impairment
- distorting loan structure to avoid the application of consumer statutes
- allocating insufficient time to review documents at closing
- mark ups on third party services
- repeated refinancing of loans over a short period of time to capture closing costs
- extending credit without regard to the borrower's ability to repay
- engineering servicing systems that encourage late payment to generate fee revenue
- incorrect calculation of interest and other charges
- ignoring correspondence, telephone calls, and otherwise refusing to provide account information
- abusive or harassing collections
- excessive and unnecessary attorney fees to borrowers in arrears
- engineering servicing systems that encourage foreclosure to generate fee revenue
- failure to properly maintain tax and insurance escrow accounts
- delay and obstruction of judicial, administrative, and consumer investigations and discovery
- unfair arbitration terms

Why has the system broken down?

Predatory Lending

Why has the system broken down?

~~Predatory Lending~~

Predatory Structured Finance